

ECONOMIC OUTLOOK

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A UNIQUE OPPORTUNITY

by

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The recent convergence of favorable political and economic events leads us to believe that the President, the Congress and the business community have been offered a rare opportunity to set the nation on a course of long-lasting economic prosperity. An optimistic statement? No doubt about it, but we are convinced that the facts support it and that economic growth rates have the potential to approach those of 1984.

What are these favorable events? First, is the collapse of OPEC and the precipitous decline in world oil prices. If oil prices were to fall to \$10 a barrel, which is certainly possible, real GNP could be at least one percentage point higher this year and next. This is not an altogether unrealistic assumption given how quickly oil prices fell below \$16 and how much further they could fall before bumping against the lifting costs in the world's major oil fields.

Our simulations of such an oil price decline on an econometric model of the U.S. economy suggest that the impact will be substantial. A \$10 per barrel price decline would increase real GNP growth by 1.2 percentage points this year, raise civilian employment by a cumulative 1.4 million jobs in 1986-87, reduce inflation by 1.2 percentage points in 1986 and 0.3 percentage points in 1987, and reduce short-term interest rates by 30 basis points in 1986 and 20 basis points in 1987.

The combination of stronger income growth and lower interest rates would also serve to reduce the budget deficit by a cumulative \$20 billion over two years. If we factor this into the Administration's forecast of four percent real growth per year, expected growth rates could rise to the 4.8 percent to 5.2 percent range this year and next.

The second major event, this one political, is the enactment of the Gramm-Rudman-Hollings Act, easily one of the most radical and potentially most effective spending

reduction proposals ever enacted by Congress. It is easy to criticize the Act, and most pundits have had a field day doing so, spewing forth an abundance of vitriolic ink that more than matches the red ink produced by Congress through their more "thoughtful" deficit reduction efforts. If found to be constitutional after full judicial review, this law could have a profound impact on spending growth.

In thinking about the many comments on Gramm-Rudman-Hollings, one is reminded of what Winston Churchill said about democracy—that it is the worst form of government except for all the others. We could easily extend this to Gramm-Rudman-Hollings. Yes it's crude, inequitable and thoughtless, but unlike all the alternatives, it works! We've already knocked \$12 billion off this year's budget and much more will be headed for the chopping block in future years. For the first time in memory, government spending will be firmly limited, choices will be made and resources will be shifted to the more productive private sector. The debureaucratization of America is at hand as government is forced to get by with less and the long-promised efficiencies are forced on the reluctant Leviathan.

With the 1987 baseline deficit projected to come in at \$178 billion, the \$34 billion of required spending reductions are well within the feasible range and give both Congress and the President an opportunity to avoid the painful process of sequestration. Moreover, with the extra economic stimulus provided by the oil price collapse, the required spending reduction targets could be even less, thereby making Gramm-Rudman-Hollings all the more workable.

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The only remaining obstacle to fulfilling the promise that these two events offer is the "successful" resolution of the tax reform debate, with emphasis on the word "successful," by which we mean a tax reform package that enhances the economy's potential through substantially lower marginal tax rates, strong incentives for capital formation, and a date certain for enactment, preferably January 1, 1987.

Regrettably, there are many obstacles blocking the way to this eminently sensible goal.

As we reported in last month's issue of ECONOMIC OUTLOOK, the tax reform package, as it is currently structured, will have a significantly negative impact on business investment. An abundance of studies, including our own, have demonstrated this. Moreover, we believe that the debate over tax reform is already having a negative impact on the economy. Congress and the Administration will not decide on, and make public, a definite effective date for tax reform. The lack of commitment from our nation's leaders has propelled the business community into a virtual twilight zone of uncertainty—a land where business investment in plant and equipment hangs in suspended animation—delayed or even cancelled due to uncertainty about the impending tax reform and the date when it will become effective.

If Congress and the Administration cannot get their act together, the lack of an effective date could greatly reduce economic growth this year as capital investment stagnates or even declines, leading to a chain reaction of deterioration throughout the economy. The delayed investment, if it continues, will have a disastrous effect on economic growth for 1986. Anecdotal evidence, much of it reaching us from U.S. Chamber members, indicates that many businessmen have already delayed investment plans because of uncertainty about the future tax code. If such uncertainty is happening on an economy-wide scale—and we have a strong feeling that it is—economic growth for 1986 could be markedly reduced. Already, three separate surveys of business capital spending plans project a decline for 1986.

The House tax reform bill, passed last December, contains various effective dates depending on the provision. Some effective dates (such as for use of the investment tax credit) are retroactive to as far back as September 26, 1985. This means that those who were not aware of the early date, or were not able to speed up an already planned investment in order to take advantage of the ITC will find themselves with a higher tax bill and a less profitable investment. By picking a uniform, effective, future date

for tax reform, some revenues would be lost, but such a loss would be partially offset by higher revenues from a stronger economy. Such revenue losses would have to be made up elsewhere in the bill as long as Congress binds itself to a goal of static revenue neutrality.

Counterproductive tax reform is not the only tax-related risk confronting us. The imposition of any form of major tax increase, including the levying of an oil import fee to cut the deficit, would squander the unique opportunity that the collapse of OPEC and the Gramm-Rudman-Hollings Act offer the U.S.

While we are optimistic about the implications of the Gramm-Rudman-Hollings Act, we have been around Washington long enough to know that this town possesses the potential for turning a useful tool into a lethal weapon.

On the pessimistic end of the process, we have two potential outcomes:

(1) First, the courts could find the amendment unconstitutional. If this occurs we revert to the Act's back-up provisions which are not nearly as effective as the provision now being challenged in the courts.

(2) Second, major tax increases could be included as part of the package.

At the optimistic end are also two possible scenarios:

(1) First, Congress could bog down in budget negotiations, triggering a \$30 billion spending sequester.

(2) Second, there is the possibility that Congress takes the amendment seriously and makes program reductions and avoids a tax increase.

Obviously, a healthy economy and an attractive political climate necessitate the occurrence of the last one, or some combination of the last two. Regrettably, the first round in the expedited judicial review process concluded that a key provision in the Act is unconstitutional. If this ruling stands on appeal, then obviously our optimism must be tempered. Nonetheless, we remain optimistic that Congress will see fit to make the Act's back-up provisions workable and achieve the required spending cuts.

With all of the potential good news emerging, it's perhaps understandable that we have managed, in our usual preoccupation with the gloomy side of life, to forget what has been happening in foreign exchange markets. Remember the exchange rate "crisis," the highly valued dollar and the exploding trade deficit? Well, that, too, is now well on the way to a satisfactory resolution. The yen, for example, which had been as high as 260 in 1985, is now trading at 190 to the dollar, a 27 percent decline in less than a year. This should go far toward rectifying the trade imbalances of the past few years, diminish protectionist pressures and begin erasing some of the red ink in our trade account.

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More importantly, it should also contribute to stronger economic growth this year. In 1985, measured GNP was reduced because so much of the growth in sales during the year was satisfied by foreign products. With a lower valued dollar, this trend should be reversed and sales growth will go right to the bottom line, for both the economy and American business.

Although the high growth scenario could be achieved, the more likely outcome for 1986 is that real economic growth will rise by about 4 percent. Our assessment of the outcome of the key policy options that need resolution is as follows: (1) The tax reform bill that will finally be enacted will not be ideal but will be better than the Ways and Means proposal; (2) It is likely that a small tax increase will be enacted as part of the deficit reduction effort, but it will not be of a debilitating magnitude; (3) A big budget fight will ensue, with some substantive spending cuts, but they will not be as large as we need; and (4) The price of imported oil will, indeed, continue to decline but it will settle in the \$13 to \$15 per barrel range, and not fall to the \$10 per barrel incorporated in our most optimistic scenario.

LIKELIHOOD OF ABOVE AVERAGE STRENGTH IN THE 1986 ECONOMY INCREASES

by
Graciela Testa-Ortiz

The preceding article outlined the possible economic scenarios now facing the United States. Again, the greatest risk surrounding this month's outlook is related to the outcome of the fiscal policy debate which has become doubly important this time around since it concerns not one, but two pieces of legislation—tax reform and deficit reduction. As the previous article mentions, the U.S. economy is poised at a crossroads. Given the correct policy choices, we could look forward to historically high rates of economic growth for the remainder of this decade. Alternatively, we could lose this opportunity to set the nation on a sustained high growth path. This month's forecast assumes that, this being Washington, fiscal policy does not fall in the optimum range, but that we are able to avoid a combination of all negative alternatives. The forecast assumes that Congress enacts deficit-reducing legislation, but falls short of the Gramm-Rudman-Hollings deficit goals. Uncertainty regarding tax reform looms so large that the forecast does not incorporate it. However, we have assumed that by midyear the doubts regarding the effective date of implementation of the bill will have been resolved.

End of year economic indicators, combined with the drops in oil prices, have renewed our confidence in a stronger economy for 1986 (see Trends in Commerce section in this issue). Most measures of economic health, from industrial production to personal income, to retail sales and housing starts posted unequivocal advances in December, closing out 1985 with a welcome show of strength. Moreover, external developments, in particular, the collapse of OPEC and the consequent slide in the price of imported oil presage higher growth and lower inflation, not only in the United States but abroad as well. As a result, we expect real GNP to rise by 3.9 percent this year and 4.7 percent in 1987.

As noted in previous issues of ECONOMIC OUTLOOK, we believe that concern regarding consumer indebtedness and the low personal savings rate is exaggerated. The latest data on outstanding consumer installment debt shows that during November, it experienced the smallest monthly advance in two years. Personal income rose a healthy 1.4 percent in December, with the bulk of the strength in the wages and salaries and farm income components. Moreover, the recent rallies in the stock and bond markets have increased consumer wealth. This, together with low rates of inflation and declining interest rates, has improved purchasing power and the outlook for consumer spending.

According to the University of Michigan survey, the consumer sentiment index rose to 94 in December and remains high relative to the early part of this decade. More importantly, respondents' optimism is based on an improved assessment of their financial situation, with a near record number reporting that they are now better off than they were a year ago. Consequently, we expect a strong showing in this sector during the current quarter, partly as a one-time adjustment to the sharp decline in purchases of durables that occurred in the last quarter of 1985. Thus, real consumer spending should continue to buoy economic activity during this year and next, rising by 3.7 percent in 1986 and 3.5 percent in 1987.

Housing starts, which behaved in quite an erratic manner last year despite continued declines in mortgage interest rates, rose by 17.5 percent in December to an annual rate of 1.84 million units. Given our assumption of continued improvements in housing affordability, as personal income and employment rise and mortgage interest rates continue to slide, we expect the residential investment sector to also contribute to this year's economic strength, rising by 11 percent compared to 1985's meager 1.9 percent increase. In such a climate, total new housing starts should reach the 1.9 million unit level with ease.

The investment sector, the mainstay of this recovery's strength, reflects the uncertainty surrounding the fiscal policy debate. Last year, business fixed investment rose by nearly ten percent, but that performance was marred

TABLE 1
UNITED STATES ECONOMIC OUTLOOK 1986-1987
 Prepared by the U.S. Chamber of Commerce
 (Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS									YEARS			
	Actual			Forecast						Actual		Forecast	
	85:2	85:3	85:4	86:1	86:2	86:3	86:4	87:1	87:2	1984	1985	1986	1987
GROSS NATIONAL PRODUCT													
Real GNP	1.1	3.0	2.4	4.8	4.3	5.2	5.9	4.3	5.0	6.8	2.3	3.9	4.7
Consumption	2.6	4.6	-0.2	5.8	4.4	3.6	3.7	4.1	2.9	5.3	3.2	3.7	3.5
Residential Investment	7.1	8.5	8.6	12.3	16.5	10.5	6.4	4.7	2.1	12.2	1.9	11.0	4.7
Nonresidential Investment	12.5	2.4	10.3	3.3	5.9	7.0	9.6	6.4	10.2	19.8	9.7	6.4	8.3
Equipment	16.9	3.0	12.4	3.2	7.4	8.1	10.4	5.9	10.8	21.5	8.7	7.5	8.8
Structures	5.2	1.2	6.4	3.5	3.2	4.8	8.1	7.2	9.0	15.6	11.4	4.3	7.3
Exports	-10.9	-5.1	8.0	13.3	18.0	17.9	16.2	17.5	16.9	4.7	-2.9	9.8	16.7
Real Net Exports	-101.1	-119.8	-127.6	-128.6	-124.2	-116.1	-111.7	-103.3	-95.2		-105.1	-120.2	-91.6
Imports	18.2	12.8	13.0	10.6	9.3	6.6	8.7	6.8	7.1	27.0	2.1	10.8	7.3
Government Purchases	2.1	37.3	16.1	-16.7	-12.9	-3.6	9.0	1.1	0.1	3.5	9.8	-0.3	0.6
Final Sales	1.2	5.0	2.1	3.6	3.8	4.2	5.2	4.8	4.2	6.0	4.0	3.6	4.4
Change in Business Inventories (825B)	15.1	-1.8	0.1	10.8	15.5	24.5	30.3	26.1	33.5	24.8	7.3	20.2	32.2
Industrial Production	2.0	3.1	1.4	7.5	5.9	8.8	10.6	6.5	8.6	10.6	2.5	5.5	7.8
New Car Sales (total, mill.)	10.9	12.4	10.3	11.3	11.8	11.7	11.7	12.2	12.7	10.4	11.1	11.6	12.1
New Domestic Car Sales (mill.)	8.2	9.4	7.0	8.6	8.7	8.7	8.7	9.2	9.2	8.0	8.2	8.7	9.1
New Housing Starts (total, mill.)	1.8	1.7	1.7	1.9	2.0	2.0	2.0	2.0	2.0	1.8	1.7	2.0	2.0
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.3	7.2	7.0	6.7	6.6	6.5	6.3	6.1	6.0	7.5	7.2	6.5	5.9
Compensation	4.1	3.7	3.7	4.7	3.1	3.2	3.3	4.3	3.7	4.2	3.9	3.8	3.7
Productivity	1.0	0.5	-1.9	2.7	1.7	2.7	2.9	1.8	2.4	2.7	0.0	1.4	2.1
Unit Labor Costs	3.1	3.2	5.6	2.0	1.4	0.5	0.4	2.5	1.3	1.4	3.8	1.0	2.4
Consumer Price Index	4.3	2.3	4.2	2.8	2.7	3.3	3.5	3.7	3.8	4.3	3.5	3.1	3.6
Implicit GNP Deflator	3.3	2.9	3.3	3.8	2.5	2.2	2.8	2.9	3.0	3.8	3.3	3.0	2.9
Prime Interest Rate (%)	10.2	9.5	9.5	9.2	9.0	8.8	8.4	7.9	7.4	12.0	9.9	8.8	7.3
3-mos. Treasury Bill Rate (%)	7.5	7.1	7.2	6.5	6.3	6.1	6.2	5.9	5.6	9.5	7.5	6.3	5.6
Corporate Bond Rate (%)	11.6	11.0	10.6	9.5	9.2	9.1	8.9	8.4	8.1	12.7	11.4	9.2	7.9
Real Personal Disposable Income	8.3	-4.6	2.5	6.0	2.6	2.0	2.9	3.6	2.0	6.7	1.5	3.4	2.2
Profits from Current Production (\$B) ¹	201.0	222.0	224.0	250.0	247.0	258.0	275.0	284.0	298.0	195.9	213.0	258.0	301.0
GOVERNMENT FISCAL POLICY (\$B)²													
Unified Receipts										666.0	736	793	862
Unified Outlays										842.0	937	998	1027
Unified Deficit										-176.0	-201	-205	-165

¹After-tax corporate profits with inventory valuation and capital consumption adjustments.

²Unified budget figures on a fiscal year basis.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the Commerce Department's benchmark revision of the National Income and Product Accounts. The forecast assumes that Congress enacts deficit-reducing legislation, but falls short of the Gramm-Rudman deficit goals. Federal outlays are reduced by \$12 billion in FY 1986 and \$35 billion in FY 1987 with the bulk of the cuts stemming from defense purchases. The money supply, as measured by M1, rises by 8.3 percent in 1986 and 6.9 percent in 1987 (on a fourth-quarter over fourth-quarter basis). The price of a barrel of imported crude is assumed to average \$13.50 in 1986 and \$13 in 1987. The trade weighted exchange value of the dollar is anticipated to fall by 4.8 percent in 1986, but increase by 1.6 percent in 1987. The federal minimum wage is expected to remain at \$3.35 an hour.

by quarterly swings in growth rates and was below 1984's increase. Business investment, and in particular, business investment in producers' durable equipment, is quite sensitive to businessmen's confidence in the nation's economy. As such, its lackluster performance is not surprising given the uncertainty engendered by the tax reform debate.

As we reported in the December issue of *ECONOMIC OUTLOOK*, an econometric study performed by Laurence H. Meyer and Associates shows that, as it is now structured, the tax reform package would have a significantly negative effect on business investment. Other studies have corroborated this view. In recent testimony before the Senate Finance Committee, Data Resources, Inc. also concluded that enactment of the tax reform package would reduce investment. These studies show what we are likely to experience if the tax reform package is enacted in its present form. Unfortunately, however, the debate itself is having a deleterious effect upon investment now.

As a result, surveys of investment intentions show real declines in capital spending for 1986. Our forecast is more optimistic in that we expect a resolution of the issue by midyear and that the effective date of the provisions will not be made retroactive. Therefore, nonresidential investment remains weak during the first half of the year, but rises during the second half, resulting in a year-over-year gain of only 6.4 percent.

The largest negative development during 1985 was, of course, the dismal performance of the foreign trade sector which, as anticipated, posted record deficits. However, there is a silver lining in the dark cloud of our massive trade deficit. The data for 1985 show that despite the fact that real net exports posted a \$105 billion decline, real import growth slowed substantially, from 27 percent in 1984 to 2.1 percent in 1985. As a result, following a quadrupling in 1984, the trade deficit increased by only 27 percent in 1985. The outlook for the foreign sector is quite optimistic. Given the lags (from nine to twelve quarters), between changes in currency values and their impact on exports and imports, the decline in the value of the dollar since its peak in February should soon begin to have an impact on trade flows. As a result, we expect to see a significant turnaround in the performance of exports and imports during this year and next.

The major piece of fortuitous economic news is the disintegration of OPEC and the collapse of oil prices which has accompanied it. The drop in oil prices has increased the odds of a prolonged expansion by reducing inflationary pressures worldwide. As a consequence of falling inflationary expectations, interest rates should also ease. Assuming that our policymakers do not embark in a misguided effort to take advantage of the oil price decline to reduce the federal deficit by imposing an oil import fee, the economy-wide benefits will far outweigh the

costs to the domestic oil industry. Globally, the decline in oil prices (which is dollar-denominated), at a time when the value of the dollar is also falling, means that oil importing countries other than the U.S. will be able to reap the full benefit of this price decline (which they had been unable to do in the past when the dollar was rising). In other words, we can expect much faster economic growth among our trading partners which will translate into increased demand for U.S. goods and services.

Our forecast assumes that the price of a barrel of imported oil falls to \$13. This is not an altogether unrealistic assumption given the fact that it is extremely unlikely that the remnants of the cartel will be able to impose any type of discipline on themselves at this stage. Saudi Arabia, the only oil-exporting country which can afford to curtail production in order to prop up prices, has made it quite clear that they will no longer play that role, particularly when other cartel members remain uncooperative.

The gains to the nation's economy of such a price decline were noted in the previous article. Unfortunately, every time the price of oil falls attempts are made to impose an import fee on it in an attempt to "take advantage of" the price decline to close the federal deficit gap. However, the historical record shows that for every one dollar of import fee, real GNP is lowered by 0.2 percentage points, and inflation and the unemployment rate rise by nearly 0.1 percentage points.

PRIVATIZING FEDERAL PROGRAMS

by

Ronald D. Utt and William Orzechowski

With or without the Gramm-Rudman-Hollings Emergency Deficit Control Act, both Congress and the Administration will be confronted with exceptionally difficult decisions regarding the course of federal spending. Despite the ongoing commitment to deficit reduction, projected federal deficits will be in excess of \$200 billion for the foreseeable future and intense efforts will be required just to keep the next year's deficit below the previous one. Gramm-Rudman-Hollings not only raises the stakes, but also provides enhanced powers to achieve the objective. In 1987 alone, it is estimated that over \$50 billion in spending reductions will be needed to meet the stipulated deficit target of \$144 billion. By fiscal year 1991, Gramm-Rudman requires that the federal budget be in balance. Meeting these objectives will require an unprecedented assault on federal spending and innovative solutions. It is our belief that an aggressive program of privatizing government programs could be an important part of the solution to this problem.

Background

Even with the enhanced powers provided by Gramm-Rudman, recent history demonstrates that the attainment of substantial deficit reduction targets through spending cuts will be a daunting endeavor. Last year was supposed to be the year that everyone got serious about the budget, but in the end it was business as usual. Congress agreed to the Administration's goal of \$55 billion in spending cuts and then proceeded to take most of it out of defense. The budget resolution passed by Congress called for \$27 billion in defense cuts, and \$22 billion in domestic spending cuts, and the remainder coming from increased taxes, user fees and other receipts. In the end, however, because Congress failed to pass the reconciliation bill needed to make the domestic cuts effective, the final tally was close to \$30 billion in defense cuts and less than \$5 billion in domestic spending cuts. But, because the recently enacted farm bill is likely to add over \$5 billion to spending in 1986, Congress' action on domestic spending is a wash, leaving defense as the only source of savings. Under these circumstances, it should come as no surprise that this year's deficit is expected to reach an estimated \$220 billion instead of the \$171 billion target set in the budget resolution. And we might note in passing that this six to one ratio of defense to domestic spending cuts is much less favorable to the President than the 50/50 sequestering split mandated by Gramm-Rudman-Hollings.

With this as background, Congress and the President embarked on another year of deficit reduction with no clear sense of how this might be achieved. Unlike last year, when a favorable political environment allowed serious consideration of cuts in all programs, the choices presently open to the budget committees will be severely limited. For starters, a large chunk of the budget, conceivably as much as 80 percent, will initially be placed off limits for a variety of reasons. The defense budget was cut by \$30 billion this year and thus offers limited opportunities for further reductions. The President will certainly dig in his heels against further cuts in this sector and many in Congress might be reluctant to go much further as well. Social Security will be off limits for political reasons. The COLA (Cost of Living Adjustment) freeze debate became intense and acrimonious this summer and few politicians will want to revisit it for at least a year or two, and then certainly not in an election year. Finally, the recently enacted farm bill will determine farm spending over the next four years. And while this issue can be reopened, this is unlikely to happen in an election year.

For these reasons and others, it will be difficult to attract much interest or support to a comprehensive budget restraint program that relies on spending cuts in most or all programs. As a consequence, there is the very real risk that Congress will ultimately opt for a major tax increase. Recall that it was an environment such as this that led to the enactment of the Tax Reform and Fiscal Responsibility Act (TEFRA) of 1982.

Despite this grim outlook, there is a politically attractive solution to the dilemma that offers substantial long-run potential for large savings: A massive and comprehensive program of privatization of every government activity that could be performed by a private sector entity. Although comprehensive privatization is not likely to generate great savings during the next fiscal year, it could yield generous savings as we approach the end of the decade.

Already sizable savings have been generated in other countries utilizing such an approach. Great Britain, for example, has realized more than \$27 billion through privatization over the past several years and expects to obtain another \$20 billion in the next three.

While such potential savings are of major importance in times like these when the deficit hovers at \$200 billion per year, the main public policy attraction of a privatization program is that it is more politically saleable than the usual menu of program freezes and exterminations, and service and benefit reductions. Privatization does not eliminate programs nor does it necessarily reduce services. Indeed, it may even lead to more and better service. Privatization merely changes the provider by placing a greater share of management and production responsibilities within the more efficient private sector.

The Privatization Option

The essential idea behind privatization is to identify those government services that could be more efficiently provided by the private sector. There are many variations on the theme with some involving partial privatization and greater participation by state and local governments. The general rationale behind privatization is to utilize the superior efficiency of the private sector and the competitive pressures of the marketplace to produce such services at the least cost possible. This entails no small gain because studies document that private firms often produce at prices which are substantially less than the average cost of similar services produced by the public sector.

The term privatization really covers several distinct ways in which government services can be shifted to the private sector. The three principal privatization mechanisms are load shedding, contracting-out and vouchers. Load shedding refers to the process whereby the government transfers complete financial and production responsibilities to the private sector. It is especially useful in the case of "private goods," that is, those services that business firms can finance and produce without government subsidy. However, it is of limited usefulness in the cases of public goods and income redistribution programs. "Public goods" refers to those services that would be inadequately provided by the private sector due to the problems of external benefits and costs which prevent the provider from collecting payments from those who benefit from the service. National defense, certain

aspects of public health, and basic law enforcement are examples of public goods. If national defense were to be financed totally by the private sector, not enough revenues would be collected because each individual would have an incentive not to contribute, hoping to enjoy the security paid for by others.

The other two methods of privatization, contracting out and vouchers, are partial privatization methods and can be used in the presence of public goods and/or in conjunction with welfare or income distribution programs. Contracting out allows the government to establish the objectives for programs and finance their cost, but places the responsibility for actual production or service provision in the private sector. Cost savings at all levels of government have been achieved through contracting out in areas spanning from garbage collection at the local level, to medical care for the aged at the federal level. Studies estimate that the savings from contracting out are impressive. An OMB (Office of Management and Budget) analysis of 1,700 cost studies indicates that existing efforts at contracting out have resulted in an average savings of 20 percent over previous cost. However, since contracting out still contains a large government role, the perils of the political process remain. Davis-Bacon and Walsh-Healy provisions, for example, are unnecessary and costly government burdens placed on private contractors. Moreover, private contractors can become advocates of dubious public programs and aggressively lobby on their behalf. For this reason, when feasible, load shedding is a superior alternative to contracting out.

Vouchers are the third main privatization method and may represent a powerful and untapped source of budget savings. With vouchers, the government still funds and sets objectives by providing what amounts to a cash grant, tied to a specific purchase, to program beneficiaries who then purchase the specific goods or services in the marketplace from private suppliers. Food stamps and student loans are good examples of existing voucher programs. A voucher is normally provided to classes of citizens believed by the government to have insufficient income. The idea is to let the government provide the individual with the means to buy a certain amount of a particular good or service, and then let the individual shop around for the best deal he can obtain. In this way, much of the cost burden associated with administering the program is avoided.

Low-income housing assistance, for example, is a program that many analysts have recognized as being suitable for vouchers. A casual survey of the literature indicates why. A CBO (Congressional Budget Office) study, for example, found that each unit of newly constructed Section 8 public housing cost \$6,000 per year, compared to a \$2,300 rental voucher program that could provide the same quality housing through the private sector. Moreover, the beneficiaries would be free to live where they wanted to rather than being isolated in low-income

housing projects. While vouchers have largely been confined to low-income programs, substantial opportunities exist in other areas such as education, and federal health and pension plans.

An Example: The United States Postal Service vs. Private Carriers

The potential for long-run cost savings through the privatization of government commercial enterprises can be illustrated through the example of the hypothetical sale of the U.S. Postal Service. Around the world and throughout most of our history, first class mail delivery has been the province of central government despite various forays into the business by private providers. Many Americans, for example, do not realize that the legendary Pony Express was a private company fulfilling a service that the Post Office could not provide. And even today, the Postal Service is subject to vigorous competition from the United Parcel Service (UPS) for packages and from a host of newly-created companies for express mail delivery.

Although nominally independent and allegedly self supporting, the U.S. Postal Service requires a federal subsidy of \$800 million a year. However, it pays no taxes and provides inferior service. If completely privatized (load shedding), it could provide budgetary savings well in excess of its annual federal subsidy since it would become a taxpayer rather than a tax spender. Consider its private sector counterparts. They provide efficient service, earn handsome profits, and pay millions in federal taxes. With only a fraction of the total postal business, UPS, Federal Express and Purolator Courier paid \$400 million in federal income taxes in 1984. The Postal Service, with a much larger revenue base, could pay over one billion dollars in federal income taxes if operated at the same standards of efficiency. But that's not the end of the story. As a potentially viable business entity, it could bring in billions of dollars if sold to the highest bidder. Generating more than \$25 billion in gross revenues per year, it has limited debt and comes with extensive real estate holdings which are valued at nearly \$7 billion at historical acquisition costs.

This example illustrates the three main sources of deficit reduction that can be achieved through privatization of government enterprises: (1) the end of a subsidy, (2) the creation of a new revenue source, and (3) the sale price. And although the sale price is a one time savings, by offsetting the deficit in any particular year, it leads to less government borrowing and a permanent reduction in future debt service costs. At current interest rates, a \$10 billion sale price leads to \$700 million in interest savings per year.

While these savings are substantial, the real potential attractiveness of privatization goes beyond the budgetary benefits and includes the opportunity for more efficient service at much lower costs and the creation of constituent

cies who stand to benefit directly from the change in ownership.

A recently-developed, postal-related business demonstrates the opportunities in this field that a private owner could take advantage of. A firm called American Discount Stamps is planning to sell a 22-cent U.S. postage stamp for 17 cents by affixing the stamp to a larger label that promotes a commercial product or service. The company believes that it can make a profit and offset the five cent loss per stamp by charging fees to advertisers. This indicates that lower postal prices could be obtained through a more creative marketing of the existing products.

The Postal Service is one of the most obvious candidates for privatization. A casual reading of the federal budget leads to hundreds more: Military commissaries, Amtrak, mass transportation, mortgage insurance, government vehicle fleet management, certain coast guard services, the Pension Benefit Guaranty Corporation, federal pensions, power marketing authorities, public housing, satellite launching, education, nuclear waste treatment, federal lands and land management, the Tennessee Valley Authority, electric co-ops and Veteran's hospitals are some of the ones that come quickly to mind. In addition, there are hundreds of less dramatic privatization options that could save billions more.

Potential Cost Savings

Although critics of privatization will often acknowledge the gains to the federal treasury from asset and enterprise sales, they dispute the existence of subsequent operating efficiencies that allow the private supplier to provide the same service at lower costs. Arguing that the government can do it more cheaply because it is nonprofit and free of state, local and federal taxes, these critics fail to consider the powerful discipline that the competitive market place imposes on private business, and how this discipline can translate into substantially lower costs and improved services. But based on numerous studies and cost comparisons, the record clearly demonstrates that the savings can be substantial. A recent article by Steve Hanke ("Privatization: Theory, Evidence and Implementation" in *Control of Federal Spending*) offers many examples of such savings, a few of which are listed below.

The federal government operates hundreds of loan programs and a high rate of defaults and delinquencies have often been a severe problem for government debt collectors. In 1984 alone, \$7.8 billion in loans were written-off and many billions more were in arrears. Part of this problem stems from costly and inefficient collection efforts. A study found that one federal agency spent \$8.72 per account to maintain and pursue debt collection, while one of the largest private collection agencies performed the same function for \$3.50. Further, private firms report that it is possible to pursue collection on debts as small as \$25

while the government typically wrote off debts for less than \$600.

The President's Private Sector Survey on Cost Control (PPSSC) found that it cost the U.S. Army \$4.20 to process a payroll check while the same function is performed by private business for \$1.00.

Air traffic control in the U.S. is provided by both the Federal Aviation Administration (FAA) and by private contractors at smaller airports. For the smallest FAA tower authorization, the FAA spends about \$1 million to install and about \$275,000 a year to operate and maintain a tower. Private firms provide the same services for about \$120,000 per year, including amortization of their original capital investment. When a private operator assumed the responsibility for operating the Farmington, New Mexico, tower, its contract was for \$99,000 per year compared to the \$287,000 that it had cost the FAA.

Maintenance of facilities at selected military installations was reduced by 35 percent when these functions were transferred to private contractors.

A study of federal and private hydroelectric plants for the years 1973-75 found similar differences. The cost per kilowatt hour of federal hydropower was \$3.29, while private hydropower was \$2.79.

The United Parcel Service handles twice as many parcels as the U.S. Postal service, charges lower rates, makes faster deliveries, and has a damage rate 80 percent lower than that of the post office.

A 1979 comparison of Amtrak with four private firms showed that Amtrak repaired 182,955 ties with an average work crew of 69, while the private firms repaired 684,339 ties with an average crew of only 26. Amtrak removed 71.8 miles of rail with an average crew of 129, while the average removed by the private firms was 344 miles with a crew of 77. The average private firm surfaced 864 miles of track with an 18 man crew, while Amtrak did 141.4 miles with a crew of 16.

Refuse collection represents a basic area of service where many municipalities have achieved significant savings by relying on private contractors. A study found that for cities with populations in excess of 50,000, private collectors were 30 percent less costly than public ones.

The Politics of Privatization

As the British have discovered, the basic thrust behind the privatization movement is its political attraction. Through the process of privatization, those in search of fiscal responsibility can disarm the claims of the powerful spending lobbies who maintain that budget cuts mean less service for the general public and hardship for the poor. Instead, privatization strives to supply the same services through more efficient private sector arrangements. As a consequence, program beneficiaries need not be alienated due to the loss of benefits and may actually gain through better service and lower prices. Just as important, the general taxpayer gains through avoidance of painful tax increases and the realization of lower deficits as privatization reduces the role of the public sector and the claims on the Treasury.

Another politically attractive dimension to a well-defined privatization program is that it easily lends itself to the development of effective, well-organized constituencies who will aggressively support it. This is in stark contrast to the kinds of pressure groups that emerge when attempts are made to achieve fiscal responsibility through the more traditional mechanism of program cut-backs and terminations. In the case of the traditional budget cutting exercise, those who support fiscal restraint do so largely out of concern and good citizenship, not because they receive any direct tangible benefits from the exercise. As such, their support for the effort usually lacks the intensity needed to win. In 1985, for example, the Deficit Reduction Coalition, an organization of over 400 trade associations and companies that united to fight for budget cuts and achieve a lower deficit, disappeared as soon as the battle turned against them, and when tax reform moved to the front of the public policy agenda. In contrast, the lobbies representing program beneficiaries, whose potential losses were real, direct and often substantial, opposed the budget cutters with a relentlessness that explains why the deficit exceeds \$200 billion, why federal spending consistently rises faster than our national income, and why the budget cutters almost always lose.

The process of privatization alters this balance of power by creating a whole new class of beneficiaries who stand to receive direct, tangible benefits from the change from government to private ownership and supply. Obviously, there are groups who would be opposed to privatization because it would lead to real or perceived losses for them. Program suppliers and public employee unions are likely to be the core of such a coalition.

However, they would have to confront a well-organized coalition that had just as much, if not more, at stake. As it stands now, such groups confront only the poorly organized taxpayer.

The Foreign Experience

Although Americans are just now getting interested in the issue, the trend toward privatization is a worldwide phenomenon, and some countries, notably Great Britain, are way ahead of us. For Britain and many developing countries, this interest is understandable and often born of necessity because their governments have intruded far deeper into their economies than has ours. In turn, this has led to the growing bureaucratization of their societies, rising government spending and burdensome taxes. In Europe, the public sector accounts for close to 51 percent of the gross national product (compared to 36 percent in the U.S. and 34 percent in Japan) and in several European countries the public sector exceeds 60 percent of the GNP. As a consequence, European countries are searching for new ways to reduce the growth of government while still maintaining essential services. Privatization has become the obvious alternative.

Since 1979, the U.K. has sold off 15 formerly nationalized industries, raising nearly \$9 billion in net revenues. The success of this operation stemmed from its political attraction. Shares in the enterprise were made available to the public at discount prices and further price concessions were offered to employees. Political support gathered momentum as a broad base of stockholders, including public employees became owners of nationalized industries. In the British Telecom (BT) case, two million Britons became stockholders, including 220,000 BT employees. Today, few politicians would want to reverse this process since many voters are now company owners or consumers who receive the benefits of lower prices and better service.

The U. K. privatization effort was not limited to just nationalized industries. One of the most politically popular endeavors has been the sale of public housing to tenants. When Margaret Thatcher took office, more than one-third of all British families lived in subsidized, government-owned housing. The Labour party's policy of increasing the supply of public housing at below market rents was a constant source of their political support. And traditionally, the Conservative party, in its efforts to reduce the growth of public spending, supported policies that would reduce public housing construction and increase rents. Not surprisingly, this strategy was an abysmal failure as otherwise conservative sympathizers voted for the Labour party in order to maintain their housing subsidies. In addition, those on the public housing waiting list were often lured to the Labour party because of its support for increased public housing production and the promise of subsidized rents.

The Conservative Party's fortunes turned for the better when it adopted a privatization strategy. Recognizing that the home-ownership desires of the typical Briton are strong, the Conservative government of Edward Heath permitted local housing authorities to sell units to tenants

at discounts of up to 50 percent from market price. Confronted with this opportunity, tenants turned their attention away from seeking rents to seeking homeownership, and the politics of government housing changed overnight. By instituting a discount program, the Conservatives outbid the Labour Party and bought out a key element of the public housing coalition. Residents gained through homeownership at discount prices, government revenues were boosted by the sales, and public spending was reduced permanently by cutting back on the public housing bureaucracy and costly rent subsidies.

Over 500,000 public housing units have been sold in the U.K. and more sales are planned. According to political observers, Margaret Thatcher's 1983 landslide success was due in part to significant vote switching among traditionally Labourite housing tenants.

Even in Japan, where the public sector takes up a much smaller portion of GNP, significant privatization efforts are underway. During the next five years, Japan's public sector will become even smaller when the government sells all or part of its stake in Nippon Telegraph and Telephone (NTT), Japan National Railways, Japan Tobacco, and Japan Air Lines. The Japanese government stands to get almost \$40 billion from the partial sale of NTT. Elsewhere, Singapore raised \$240 million by selling a minority interest in its airline. Turkey signed a contract with Morgan Guaranty to prepare a master plan for the privatization of 32 state enterprises and Mexico, whose government now owns more than a thousand enterprises compared to 86 in 1970, has also announced privatization plans.

Conclusion

Although the U.S. was fortunate enough not to succumb to the temptation to nationalize vast segments of its economy, it nonetheless owns and operates hundreds of commercial enterprises throughout the nation. And while the original reason for their creation may have been sound, the rationale for their continued federal ownership and subsidization may no longer exist. The Rural Electrification Administration (REA) may have been a good idea in the 1930s when large segments of rural America were without electrical power, but this problem was resolved by the 1950s. Nonetheless, the REA continues to exist and to grow larger and more costly with each passing year.

Why do we continue to subsidize these enterprises? In large part we do so because the program beneficiaries, bureaucrats, and suppliers constitute a formidable lobbying force. Privatization, by promising to deliver better service at lower prices, can help offset the pro-spending lobby and thereby tip the political balance in favor of the general taxpayer.

ARE CREDIT CARD INTEREST RATES TOO HIGH?

by
Rajni Bonnie Ohri

Recently, a number of observers have noted that since the early 1980s, interest rates on bank credit cards have edged up even though market rates, which represent funding costs, have fallen substantially. Some commentators may have misinterpreted the resistance of credit card rates to downward pressure as an indication that the market for credit card lending is not competitive—a premise that underlies the legislation currently pending in Congress. Although the stickiness of rates might lead some to conclude that competition is lacking in this area, other characteristics of the market suggest that competition is, in fact, intense: There are thousands of card issuers, millions of cards in circulation, and varied entrants with new products surfacing frequently.

Like all attempts to interfere with the operation of an efficiently working market, a federally mandated ceiling on credit card interest rates would have serious effects on the U.S. economy if it prevented interest rates from rising to market-clearing levels. From extensive experience with state-imposed limits and the imposition of credit controls in 1980 (which led to a sharp contraction in consumer spending), we know that regulatory measures can, at times, have unpredictable and undesirable consequences. The evidence suggests the possibility of a reduction in the supply of credit in proportion to the degree of restraint imposed by the ceiling. The reduction in credit availability could take the form of a shift in credit flows away from consumers to other sectors of the economy in an attempt to avoid the ceiling. Empirical evidence also indicates that a below-market usury ceiling would lead to nonprice credit rationing by lenders who would discriminate against low- and moderate-income borrowers and small businesses. Finally, imposition of a legal limit on interest rates runs contrary to the trend toward credit market deregulation embodied in the Depository Institutions Deregulation and Monetary Control Act of 1980.

Two legislative proposals currently exist in Congress that would establish nationwide ceilings on credit card interest rates. One of these bills, H.R. 1197, sponsored by Representative Mario Biaggi (D-NY), would limit the rate of interest on any credit card transaction to no more than five percentage points above the Federal Reserve discount rate. The other bill, H.R. 3408, introduced by Representative Charles Schumer (D-NY), would limit the interest rate on credit card debt to six percentage points above the yield on three-month Treasury bills during the

previous calendar quarter. The limits imposed by H.R. 3408 would not become effective if the Federal Reserve determined that prevailing loan rates reflected the cost of funds for creditors and competition for credit card accounts. Both bills would set floating ceilings on credit card rates that would supersede generally less restrictive state-imposed limits.

Misguided Rationale for Federal Limits to Interest Rates

Although misguided, the temptation to impose federal limits on credit card rates stems from the recent U.S. experience with high interest rates. However, such measures are inappropriate because prices—in this case, interest rates—generated by the interaction of supply and demand in well-organized competitive markets, merely reflect an optimal adjustment of these forces to perceived economic circumstances, both present and future. Consequently, artificial restrictions on prices are equivalent to killing the messenger who brings bad news. The problem is not eliminated; we simply lose the benefit of the messenger's service.

Proponents of federal limits on interest rates view them as a way to prevent lenders from exploiting unsuspecting borrowers. Although this is a legitimate goal, it is not clear that interest rate ceilings do anything to promote it. In the first place, most business people do not need the "protection" afforded by interest rate ceilings because they have ample experience in negotiating credit terms on their own. Consumers and inexperienced borrowers, on the other hand, are adequately protected by truth-in-lending laws which require that the terms of credit be stated in clear, understandable language.

When interest rates discourage lending and encourage borrowing so that demand for credit is greater than the available supply at the legal ceiling rate, lenders will naturally favor the most credit worthy customers. The result is that the poor and the small, risky businesses obtain little or no credit. Those who would have credit anyway are able to borrow at lower rates, unhampered by competition from those less advantageously situated who can compete effectively only when markets are free and unrestricted. Eight independent investigations indicate that when there are usury ceilings, customers who are deemed to be poor credit risks are simply denied credit by lenders. These customers tend to be low- or moderate-income individuals or even young adults who have yet to establish credit records. These persons have no recourse but to go without credit or else obtain it from illegal sources. This nonprice rationing could be prevalent among commercial lenders as well, with adverse consequences for small businesses which rely heavily on external funds.

In fact, the most effective way to prevent exploitation in a market setting is to promote competition among

sellers, especially price competition. By contrast, nonprice competition, to which usury ceilings lead, contributes to inefficiency and unfairness. Thus, usury laws in general are counterproductive because they both restrict competition and encourage discrimination by lenders.

Inefficient Business Practices

When interest rates rise, as they did after 1977, consumers, businessmen and farmers in states with restrictive interest rate ceilings find obtaining credit more difficult than do their counterparts in areas with less stringent ceilings. However, large businesses can often seek credit at alternate sources, something their smaller competitors may find difficult or impossible to do. This puts small firms at a comparative cost disadvantage and thus, hinders their ability to compete. In short, restricting competition in credit markets can actually lead to less competition in product markets.

Even those firms which can obtain credit at market interest rates in other states may resort to inefficient business practices as a result of interest rate ceilings. The best examples are firms with "big ticket" items, such as construction and agricultural equipment. Because their customers in states with usury ceilings often have difficulty securing credit, these companies attempt to compensate by offering seller financing through captive credit companies. This expansion into the business of granting credit is contrary to the principle of specialization, which is the major source of economic progress. Moreover, the lending activities of these credit companies typically reduce the overall profitability of the company's operations within the restricted states.

Is the Market Competitive?

A critical issue in any discussion of price ceilings is whether the market involved is competitive. To assess whether the market for credit cards is competitive, the adequacy of the pricing system and the evidence of what happens in the marketplace needs to be examined.

As the evidence reveals, rate disclosure in the industry appears to be effective. In the consumer credit area, a uniform system for pricing credit was established in 1968 under the principle that consumers "should be able to shop for credit just as they shop for meat and potatoes." Once effective price comparisons are possible, we should be able to assign control of prices of meat, potatoes and credit to the marketplace rather than to the legislature. Rates are also competitive. Although most offerings are near 18 percent, the actual available range is from 14 to 21 percent (see Table 1).

It seems as though every day additional entrants announce their intention to break into the credit card field. Sears, Shell, and Household International are all currently attempting to promote new products. There are approx-

imately 130 million bank cards in the possession of consumers. In addition, there are over 350 million retail credit cards, 113 million oil company cards, and several million other types of credit cards. Approximately 15,000 financial institutions participate in some form of card program. In such an environment, the marketplace is a very accurate determinant of the value of the product. Any potential competitor who does not offer the appropriate value level for the cost of the product will be quickly abandoned for someone providing a better deal.

TABLE 1
Selected Credit Card Rates

Institution	Cards Offered	Annual Finance Rate (%)	Annual Fee (\$)
Manufacturers Hanover	VISA	17.8	20
	MASTERCARD		
Citicorp	VISA	19.8	20
	MASTERCARD		
Citicorp	CHOICE	21	NONE
Bank of America	VISA	19.8	18
	MASTERCARD		
Sovran Bank	VISA	18	15
	MASTERCARD		
Dominion Bankshares, Inc.	VISA	18	15
First Virginia Banks Inc.	VISA	18	15
	MASTERCARD		
Dominion Federal S&L	VISA	19.8	15
	MASTERCARD		
First American Bankshares, Inc.	VISA	18	15
	MASTERCARD		
Perpetual American Bank	VISA	19.8	15
	MASTERCARD		
Maryland National Corp.	VISA	18.9	18
	MASTERCARD		
Equitable Bancorp	VISA	19.8	18
	MASTERCARD		
Chevy Chase S&L	VISA	14	12
	MASTERCARD		

It is important to recognize that the disclosed rate is not the only element of competition. Focusing only on the interest rate overlooks the variety of services provided by credit cards as well as the variety of pricing systems. For example, some bank cards provide credit towards the purchase of merchandise at a discount that is based on the amount charged on the card. Some banks carry an annual fee; others do not. Available credit lines vary, as do credit standards. Thus, consumers may choose from a variety of credit card services and an array of different price systems. The stability of interest rates on credit cards does not mean the absence of competition. Services provided with a card and other pricing aspects of the card, rather than the quoted rate, may be the focus of competition.

Competition is also evidenced by various factors which determine card issuers' actions. Within the past few weeks, Manufacturers Hanover has reduced its bank card rate to 17.8 percent from 19.8 percent. Also, Sears is marketing its Discover card without an annual fee for the first two years. And Citicorp is test marketing a pre-approved Visa card that waives the usual \$20 fee for the first year. If markets were noncompetitive, there would be no incentive for card issuers to cut their rates or eliminate their annual fees. Nor would there be a significant barrier to retailers' assessing an annual fee.

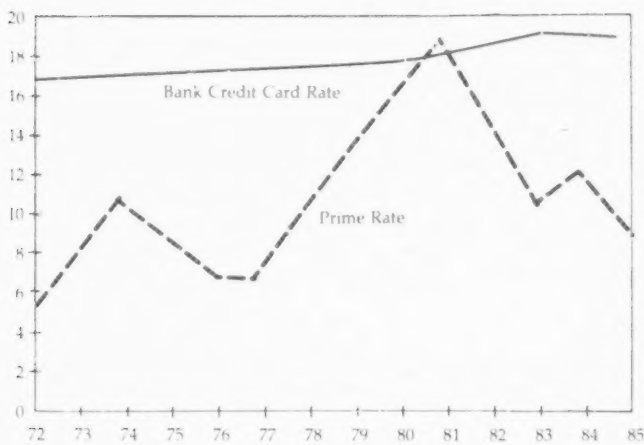
Indices of Credit Card Costs

A popular argument made concerning the current level of credit card rates is the comparison between the prime rate and the current average bank credit card rate. This, however, is the classic apples and oranges comparison. The prime rate is often referred to as the rate that banks charge their best customers for secured short-term credit. Credit card loans, in contrast, bear few of these characteristics.

Many media reports regarding credit card interest rate ceilings have created a crisis environment by tracing the relationship of average rates on bank credit cards to the prime rate from 1980 to the present. However, the evidence is faulty for the following reasons: First, selection of the base year is misleading. Deleting all information prior to 1980 conceals the fact that 1981 was an odd year in many ways, not the least of which was the very high prime rate that prevailed in that year. In August 1981, the prime rate averaged 20.5 percent; the annual rate on three-month Treasury bills was 15.5 percent. If the relationship of bank card rates to prime rates is disclosed for earlier years, the distortion introduced by viewing only the period after 1980 is apparent. As Chart 1 shows, after examining the period since 1977, there is no significant relationship between bank card rates and prime rates. The spread of bank card rates over prime rates has varied from 9.37 percent in October 1977 to -2.72 percent in August 1981 to 9.12 percent in August 1985.

Second, credit card rates and the prime rate are not properly comparable. However, comparisons are attempted because of a belief that the prime rate somehow express the costs to banks and retailers of providing revolving credit. This is not the case. The cost of funds represents only a portion of the total costs of revolving credit, and the prime rate does not adequately represent the cost of funds used by banks and retailers to finance their accounts receivable. In total, the cost of funds is only about half of the total costs of providing revolving credit. Data from the recent Functional Cost Analysis by the Federal Reserve Board show that the cost of funds comprised only 36 percent of total costs of medium-sized card-issuing banks and 40 percent of total costs of large-sized card-issuing banks.

CHART 1
MOVEMENTS IN BANK CREDIT CARD RATE
AND PRIME RATE
(1972-1985)



Source: Federal Reserve System

Clearly, over the past two decades, the credit card has come to represent a safe, secure, convenient means of payment and credit access for consumers and businesses that is almost universally accepted. In order to provide this combination of convenience and security, the bank card industry has invested heavily to develop sophisticated and costly telecommunications systems which are unique to this type of credit. These added costs contribute substantially towards making this flexible service one of the more costly forms of consumer credit.

In addition, the costs of extending open-end credit through a bank credit card are higher than through traditional installment credit. The processes differ in two key respects: risk and volume. Credit card applications are received by mail; personal interviews with the prospective customer are not typical. This aspect of credit card programs makes them inherently riskier since the customer is usually unknown to the bank. It is by definition a more risky form of credit which is susceptible to difficult collections and bankruptcy losses. The second key distinguishing factor is volume. Most bank card operations process a high volume of applications. Since over 50 percent of the dollar volume of transactions is paid off in full every month and never incurs a finance charge, card programs generate high volumes to defray enormous fixed costs associated with running such an operation.

Recently, there has developed a significant new cost to the system, that of fraud and counterfeiting. Credit card fraud losses are estimated at \$80 million a year according to a recent survey by the American Bankers Association. This problem has led the industry to devote substantial resources to developing a card that is more difficult to alter. In addition, since issuers of credit cards are unsecured creditors, they seldom realize any recovery on

the debts owed by consumer bankruptcies. Last year, Citicorp VISA lost over \$500 million in credit card debts.

Third, proxies for the prime rate are equally unsatisfactory indices of credit costs. Just as the prime rate is not an acceptable indicator of credit costs over time, the discount rate on 90-day commercial paper at Federal Reserve banks and yields on three-month Treasury bills suffer from the same deficiencies. Both are measures of the cost of short-term money, as is the prime rate. While their fluctuations over time closely mimic movements in the prime rate, they bear little or no relationship to the total costs of providing bank or retail revolving credit. In addition, both rates are inexact measures of either marginal or average costs of loanable funds, which may reflect borrowing at a wide range of maturities. Furthermore, the discount rate is a tool of monetary policy and as such, it is an administered rate that reflects broad policy considerations that are frequently complex and so may deviate from other market rates, even those for instruments of comparable maturity.

Stability of Credit Card Rates

Viewed in the longer perspective, the question of why credit card rates have not dropped during the recent period as sharply as other rates necessarily poses the analogous question of why credit card rates did not increase in previous years when other rates surged. The stability of credit card rates reflects the lesser role of financing costs in the overall cost function. It also reflects the impact of state-established statutory ceilings on interest rates.

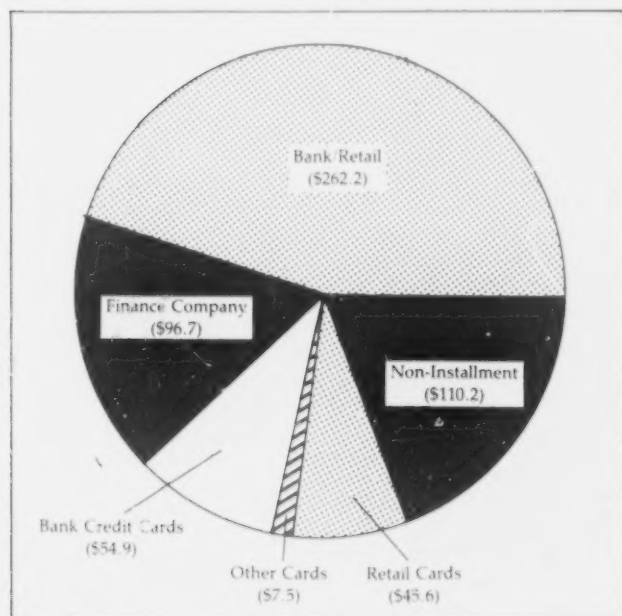
Credit card rates throughout the 1970s are not significantly different from the current average credit card rates. In the late 1970s and early 1980s, when the cost of funds significantly surpassed any previously recorded highs, credit card rates, due in many cases to usury ceilings, were unable to rise in accordance with the cost of money (in most states, 18 percent per year was the upper limit on rates that card issuers could charge on credit card balances). Yet, many institutions kept their portfolios despite losses during the period, while other providers sold their portfolios because they were a drain on bank performance. The credit card business has only recently returned to profitability, and given the reality of the market, it is clear that any effort to charge more than the market rate will be quickly undercut by scores of aggressive competitors.

Now that market funds have moved to lower levels, and credit card programs generally have become profitable again, many credit card issuers have greatly intensified their efforts to market new credit card accounts and to encourage account usage. That is, credit card issuers in general have responded to falling finance costs not by reducing rates, but mainly by increasing the availability of credit cards. This reversed the earlier curtailment of

such credit that card issuers undertook as market rates moved up and they were unable to adjust revenues to match rising costs. Thus, it appears that much of the inertia in credit card interest rates may be attributable to the influence of restrictive rate ceilings imposed by the states.

Factors on the demand side of the market may also have contributed to the observed stability of credit card rates. A substantial portion of card holders either use their credit cards infrequently or usually pay off their bills in full; these holders are likely to be largely unconcerned about the level of finance charges. Even card holders who "roll over" their balances and pay finance charges may often be relatively insensitive to the rate of interest charged. Other features of credit card borrowing, such as convenience and suitability for small transactions, may outweigh any rate disadvantage. In any case, credit card debt has expanded rapidly in the last two years—a sign that consumers view credit card use as a desirable source of short-term financing despite what many observers regard as high interest rates. Indeed, cardholders will charge about \$331 billion in goods and services this year, up from \$293 billion in 1984 (see Chart 2).

CHART 2
CREDIT CARD CREDIT
AND TOTAL CONSUMER CREDIT
(\$ billions)
1984
Total Credit Outstanding = \$577.1 Billion



Source: Federal Reserve Bulletin, September, 1985

Furthermore, the recent appearance of above-average returns to bank credit card lending may not lead to an immediate, widespread reduction in rates. Indeed, instead

of offering lower finance rates, creditors may choose to compete by easing credit standards somewhat or by making non-interest rate credit terms more attractive.

Macroeconomic Effects of Rate Ceilings

Legislation which would restrict the ability to compete freely would only hurt the consumer by restricting the availability of a valuable array of services. Faced with a rate ceiling in a competitive market, bankers must find some means of offsetting the revenue losses from such a constraint. Banks can change their method of assessing finance charges, very likely by eliminating the "free period" and charging from the date of posting. In addition, they could raise the non-interest costs of obtaining credit by increasing the following: annual fees on credit cards, processing charges levied on each purchase or cash advance, and penalties for late payments or for exceeding the authorized credit limit. Some card issuers also may apply the reduced finance charges from date of purchase, where permitted, rather than after the grace period expires, and seek to increase the merchant discount fees. Consumers would probably react by further reducing the number of cards they hold. Such actions might very well lead to a greater concentration of bank cards in the hand of fewer banks.

In particular, banks could raise their merchant discounts; that is, the price they charge merchants to buy the bank card credit slips signed by consumers. Evidence supporting this price adjustment is found in a study conducted by the Credit Research Center of merchant discounts in Arkansas at the time all credit was subject to the ten percent usury ceiling. Whereas the average discount rates paid by retailers on bank credit cards ranged from two percent in Illinois to 3.6 percent in Louisiana, the average merchant discount paid bankers by Arkansas retailers was 5.5 percent.

Increases in merchant discounts will affect both retailers and their customers. On the one hand, small merchants carrying low-priced items would be affected more adversely than large retailers with "big ticket" items. The lower the volume of business and the lower the average sales ticket, the higher will be the merchant discount. Consequently, smaller retailers selling low-priced goods may be forced to discontinue accepting bank cards in order to remain competitive on their cash prices. Such actions will adversely affect their customers. Larger merchants, who also operate in a competitive environment, will have to pack the higher costs of accepting credit cards into their cash prices. Many consumers who purchase with cash do not have bank cards because their incomes or other indices of risk do not justify their receiving a card. Thus, cash buyers will be forced to subsidize credit buyers.

Banks may also respond to a credit card ceiling by lowering costs, especially the costs of bad debts. In other

words, they will raise their credit standards and deny credit to low- or moderate-income individuals. This non-price rationing could be prevalent among commercial lenders, with adverse consequences for small businesses which rely heavily on external funds.

Numerous studies on the impact of state-imposed usury laws on consumer and mortgage credit have all concluded that a reduction in the supply of credit below the amount which would have been offered in their absence has occurred. For example, the presence of usury ceilings on conventional mortgages within a state has been found to reduce the availability of mortgage credit and the number of housing starts within the state. For each percentage point below the estimated market-clearing rate, mortgage interest ceilings appear to reduce housing starts by 16 to 28 percent below their "free-market" levels. Business and agricultural investment in plant and equipment is probably affected in much the same way when state usury ceilings on commercial and agricultural credit are below market interest rates. Fortunately, the Federal government has permanently preempted state usury laws affecting residential first mortgage loans.

Since an adequate supply of credit is vital to the health of an economy, it follows that artificial restrictions leading to diminished credit supplies or to a misallocation of credit resources would have a deleterious effect on commerce. The only major study examining this question supports this distressing conclusion. The study estimated the macroeconomic costs to the state of Tennessee from 1974 to 1976 due to its comprehensive ten percent interest rate limitation (Richard Gustley and Harry Johnson, *Impact of the Tennessee Constitutional Usury Limit on the Tennessee Economy*, Center for Business and Economic Research, The University of Tennessee, June 1977). The study found that the state usury law resulted in an average loss of output of \$150 million a year, an average loss of 7,000 jobs per year, retail sales losses of \$80 million per year, and losses to financial intermediaries of \$1.25 billion a year. Clearly, the economic cost to the national economy of such a law as a federally mandated ceiling on credit card interest rates would be staggering.

Conclusion

The available evidence confirms the predictions of economic theory regarding the adverse effects of interest rate ceilings. When such restrictions result in artificially low interest rates, they reduce the supply of credit and lead to inefficient, discriminatory nonprice credit rationing. These distortions impose enormous costs on the economy and discriminate against low-income borrowers and small businesses, who are forced to go without credit.

TRENDS IN COMMERCE NOTES ON TABLE II JANUARY/FEBRUARY 1986

by
Martin Lefkowitz

Gross National Product (GNP)— The Department of Commerce's preliminary estimate of the nation's economic performance as measured by Gross National Product—the value of the output of goods and services—shows that the inflation-adjusted growth rate for the fourth quarter was 2.4 percent. In the third quarter, real GNP increased by three percent. Real GNP growth over the four quarters of 1985 was 2.5 percent. The composition of GNP changed abruptly last quarter because of the plunge in new car sales, causing total consumer spending to decline by 0.2 percent, compared with an increase of 4.6 percent in the third quarter. Real final sales and real business inventory investment accounted for most of the fourth quarter increase. Within final sales, fixed investment and government purchases rose substantially, while the fall in personal consumption expenditures was the major negative factor. The star performer for the quarter was business investment which increased at a 10.3 percent annual rate.

The Services Sector— Employment in service sector establishments rose by 260,000 in December and is now 2.9 million above its year-ago level. This compares with an increase of 91,000 jobs in the goods-producing sector over the last year. Almost 97 percent of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services, which comprise 51 percent of total personal consumption expenditures, rose by 1.7 percent in December. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 21.1 billion in December, an increase of 14.3 percent from last year. For all of 1985, major U.S. carriers reported an 11.3 percent increase in revenue passenger miles flown compared to 1984.

Money Supply— The nation's money supply—as measured by M-1, currency in circulation plus demand deposits—increased by 1.1 percent from November to December, nearly the same as in the previous month. Money supply growth has slowed to an 8.2 percent annual rate in the latest three-month period, but is still up 11.8 percent above its level of the last year, and remains considerably above the Fed target range of three to eight percent.

Employment— The civilian unemployment rate fell 0.2 percentage point, to 6.7 percent in January, reaching its lowest level since March 1980. The January data set new records for civilian employment which has reached 109.0 million. The percent of the adult population employed also hit a record level: 60.4 percent. Civilian employment—as measured by the monthly survey of households—increased by 397,000 persons in January (seasonally adjusted), following an increase of 237,000 from November to December. The number of nonagricultural payroll jobs—as measured by the monthly survey of business establishments—increased by 566,000 in January, the largest gain since September 1983, and included an increase of 35,000 in manufacturing jobs.

Prices— The Consumer Price Index for all urban consumers (CPI-U) increased 0.4 percent in December following a 0.6 percent jump in November. Consumer prices rose at an average annual rate of 4.2 percent during the fourth quarter, almost double the 2.3 percent rise experienced during the third quarter. The December rise, however, appears to be an aberration, not a change in the trend toward lower inflation rates that we have been experiencing for the last four years. For the second consecutive month, substantial increases in food and energy prices were responsible for the larger than average monthly increase in the CPI. Consumer prices rose by 3.5 percent in 1985, a significant improvement over 1984's 4.3 percent increase.

Wholesale prices of finished goods increased 0.4 percent from December to November and are 1.8 percent higher than their year-ago level. The major contributing factors in this increase were a surge in food prices and a rebound in auto prices.

Crude goods prices fell 0.2 percent in December, following two months of strong gains. Crude goods prices rose a total of six percent in October and November, with crude food prices jumping over 12 percent. Crude goods prices showed a 5.5 percent decline from their year-ago level, with all major categories down except construction materials. Crude energy materials fell 4.3 percent in 1985, foodstuffs and feedstuffs declined 6.4 percent and other raw materials were down 4.5 percent.

Housing Starts— Privately owned housing units were started at a seasonally adjusted annual rate of 1,840,000 in December, an increase of 17 percent from the November level. Sales of new homes surged 12.1 percent in 1985, hitting their highest level since 1979. Most of the improvement in starts and sales is attributable to steady declines in mortgage interest rates as both fixed-rate and adjustable rate mortgage rates have fallen by about 1.5 percentage points over the past year. Building permits, an indicator of future activity in the home building in-

dustry, increased 11 percent. Both housing starts and building permits have been fluctuating erratically in recent months and appear not to show a particular trend at this time.

Industrial Production— Industrial production increased by 0.7 percent in December, following a revised 0.6 percent jump in November.

The capacity utilization rate in manufacturing increased to 80.3 percent in December from 80.1 percent in November. The increase in the operating rate was widespread, with motor vehicles and parts showing the largest rise (3.6 percentage points). Manufacturing capacity rose 0.6 percent in the third quarter of 1985, a 3.0 percent increase from a year ago.

Productivity— Nonfarm business productivity fell at a 1.9 percent annual rate in the fourth quarter as moderate advances in output were outweighed by strong gains in hours (3.9 percent). For 1985 as a whole, productivity was unchanged in nonfarm business, and was up by 2.7 percent in the manufacturing sector.

Interest Rates— The prime interest rate, which still remains at 9.5 percent, is one percentage point below the rate prevailing at this time last year. The three-month Treasury-bill rate fell by 0.3 percentage points from December 3 to January 31, 1986. Thirty-year Treasury bonds have fallen by 0.6 percentage points during the same period.

Business Failures and Formations—Dun and Bradstreet's Index of Business Failure indicates that business failures for the first 11 months of 1985 were up over ten percent from the same period in 1984, and that total business closings rose by about 14 percent.

Dun and Bradstreet reported that 334,831 new business corporations were formed in the first six months of 1985, an increase of 2.8 percent from 1984. Seven of the nine census regions had an increase in new business corporations formed in the first six months of 1985 compared to 1984. The New England and South Atlantic regions reported the largest gains in incorporations, while the Pacific and West North Central regions reported declines. There were 1.9 percent fewer new business corporations formed in June of 1985 as compared to June 1984, with 15 states reporting declines of over ten percent.

Federal Spending— The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased by 8.4 percent in December compared to its year-ago level. Federal receipts for the first three months of the fiscal year increased by 6.7 percent, while expenditures for the same period rose by 6.4 percent. The federal deficit for the first quarter of fiscal year 1986 stood at \$76.7 billion compared to \$72.4 billion during the first quarter of the last fiscal year.

TABLE II
TRENDS IN COMMERCE

		Current Period	Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Nov/85	240.1	239.9	237.9	0.1	0.9
Gross National Product (\$B)	IV/85	4,075.1	4,016.9	3,825.5	1.4	5.8
Gross National Product (82\$B)	IV/85	3,605.0	3,584.1	3,515.6	0.6	2.5
Money Supply (M1) (\$B)	Dec/85	624.7	617.9	558.5	1.1	11.9
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures (\$B)	Dec/85	2,675.1	2,621.6	2,503.4	2.0	6.9
Personal Consumption Expenditures (82\$B)	Nov/85	2,317.3	2,312.8	2,265.4	0.2	2.3
Disposable Personal Income (\$B)	Dec/85	2,878.6	2,837.8	2,737.8	1.4	5.1
Disposable Personal Income (82\$)	Nov/85	2,508.4	2,510.2	2,481.1	-0.1	1.1
Personal Savings Rate (%)	Dec/85	3.7	4.2	5.6	-0.3[b]	-1.9[b]
Civilian Employment (millions)	Jan/86	109.0	108.2	106.4	0.7	2.4
Civilian Unemployment Rate (%)	Jan/86	6.7	6.9	7.4	-0.2[b]	-0.7[b]
Average Hourly Earnings	Dec/85	\$8.75	\$8.67	\$8.47	0.9	3.3
Consumer Price Index (All Urban, 67=100) [a]	Dec/85	327.4	326.6	315.4	0.4	3.8
Purchasing Power of the Dollar (67=\$1.00) [a]	Dec/85	0.305	0.306	0.317	-0.3	-3.8
Prime Interest Rate (%) January 31, 1986		9.5	9.5	10.5	0.0[b]	-1.0[b]
Retail Sales (\$)	Dec/85	117.9	115.6	110.5	1.9	6.6
SERVICES SECTOR						
Employment in Services (Millions)	Dec/85	73.9	73.7	71.0	0.3	4.1
Consumer Purchases of Service (\$B)	Dec/85	1,363.7	1,341.3	1,263.7	1.7	7.9
Consumer Purchases of Service (82\$B)	Nov/85	1,128.5	1,122.7	1,107.1	0.5	1.9
Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Dec/85	25.7	22.2	22.7	15.8	13.2
BUSINESS PROFITS AND OUTPUT						
Nonfinancial Corporate Profits (\$B) [a]						
Before Tax [a]	III/85	228.6	218.7	227.7	4.5	0.4
After Tax [a]	III/85	141.1	136.4	140.3	3.4	0.6
Industrial Production (77=100)	Dec/85	126.0	125.1	123.3	0.7	2.1
Capacity Utilization Rate (Mfg.) (%)	Dec/85	80.3	79.9	80.9	0.4[b]	-0.6
New Housing Starts (thou. units)	Dec/85	1,840.0	1,566.0	1,630.0	17.5	12.9
Net Business Formation (67=100) [a]	Dec/85	115.1	117.1	116.6	-1.8	-0.4
New Business Incorporations (Thousands)	Jul/85	53.9	55.3	52.1	-2.5	3.5
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77=100)	IV/85	169.8	167.6	163.6	1.3	3.8
Unit Nonlabor Costs (77=100)	IV/85	160.1	161.8	158.9	-1.1	0.8
Producer Price Indices (67=100)						
Crude Materials	Dec/85	304.7	305.6	322.4	-0.2	-5.5
Intermediate Goods	Dec/85	318.8	318.1	319.9	-0.4	-0.3
Finished Goods	Dec/85	297.2	296.7	292.0	0.4	1.8
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67=100)	Dec/85	640.2	645.4	590.7	-0.8	8.4
Federal Government Debt Outstanding (\$B) [a]	Sep/85	1,827.4	1,822.4	1,576.7	0.3	15.9
INTERNATIONAL TRADE						
Exports of Goods & Services (\$B)	IV/85	369.7	363.2	389.5	1.8	-5.1
Imports of Goods & Services (\$B)	IV/85	466.9	451.0	461.7	3.5	1.1
Balance on Goods & Services (\$B)	IV/85	-97.2	-87.8	-72.2	10.7	34.6
WHAT'S AHEAD?						
Index of Leading Indicators (67=100) [a]	Dec/85	173.6	172.0	164.1	0.9	5.8
NOTES: All data seasonally adjusted unless otherwise noted						
[a] Not seasonally adjusted						
[b] Percentage point difference						

Personal Savings— In December, the personal savings rate was 3.7 percent of after-tax income, an improvement from the 2.8 percent rate reached in October. Personal savings were \$106.1 billion in December, compared with \$120.3 billion in November. For 1985 as a whole, savings as a percent of disposable income fell to an all-time low of 4.6 percent.

Retail Sales— Retail sales increased by 1.9 percent in December following a revised 0.7 percent increase in November. Sales were up 6.6 percent from their year-ago level. Much of the December rise was due to a 5.7 percent gain in auto sales, prompted by dealer incentives. Fourth quarter retail sales were 0.7 percent below the third quarter but were 5.6 percent above the same quarter a year ago. Durable goods sales in December increased 9.3 percent from their year-ago level; automotive sales rose ten percent from last year's level. December non-durable goods sales increased 0.6 percent from November and 5.1 percent over its year-ago level.

Trade Deficit— The trade deficit continued to increase in the fourth quarter, reaching \$148.5 billion for 1985 as a whole. On a goods and services basis, the trade deficit averaged \$97 billion in the fourth quarter, compared to \$88 billion in the third quarter. For the year, the trade deficit on a goods and services basis was \$74.4 billion, an increase of \$15.2 billion from 1984. On a monthly basis, the December merchandise trade deficit reached a record \$17.3 billion, the highest monthly deficit in history. Most of the increase in the 1985 trade deficit was attributable to lower exports rather than a higher level of imports. For the full year, imports rose six percent from their year-ago level while exports fell 2.2 percent.

What's Ahead— The composite index of leading indicators, designed to predict future movements in aggregate economic activity, posted its eighth consecutive monthly increase in December, rising by 0.9 percent. Higher stock prices, an increase in the number of building permits issued and a longer factory workweek were the major reasons for the gain in the index. The 5.8 percent increase in the index for all of 1985 was significantly greater than the 0.4 percent increase in 1984.

NATIONAL CHAMBER FOUNDATION PUBLICATIONS

The following is a description of published studies available through the National Chamber Foundation (NCF), a public policy research organization affiliated with the U.S. Chamber of Commerce. The National Chamber Foundation conducts studies on emerging economic issues of importance to the business community. NCF is dedicated to action-oriented projects providing

needed analysis on important issues, outlining policy options, and ensuring that these options are translated into action.

Self-Discipline, Schools and the Business Community

This joint effort by the National Chamber Foundation and the Council on Trends and Perspective, examines the apparent failure of America's education system to teach basic workplace skills, such as self-discipline, organization, and analysis. The report was prepared by noted sociologist, Dr. Amitai Etzioni. (\$8.50)

Strategies for Hispanic Business Development

This three monograph report, the culmination of a three-year study, examines the past growth, current status and future potential of the Hispanic business community in the United States, a segment largely unknown to or misunderstood by American business as a whole. The report's author, Dr. Richard Arellano, a former State Department official, states that the Hispanic business community is an underutilized national resource with tremendous potential. It is clearly in the interest of the entire nation to see the Hispanic business sector reach its full potential. NCF's report details specific actions which should be undertaken by the Hispanic community, the American business sector and the U.S. government to achieve this end. (\$30.00)

Immigration, Refugees and American Business

America's immigration problem is rapidly reaching crisis proportions. Dr. Michael Teitelbaum's *Immigration, Refugees, and American Business* dissects this complex issue and analyzes how current U.S. immigration policy affects our nation's business community. The report recommends new private and public sector approaches to this controversial problem. (\$8.50)

Making U.S. International Economic Policy

This report discusses ways that the United States can better coordinate the various aspects of its international trade policies, much the same way that it now coordinates all decisions affecting our nation's defense. Robert Hormats, formerly Deputy U.S. Trade Representative, is the author of the report, which NCF released in March 1984. (\$6.50)

National Health Care Strategy

Five monographs entitled: How Business Interacts with the Health Care System-How Business Can Use Specific Techniques to Control Health Care Costs-How Business Can Stimulate a Competitive Health Care System-How Business Can Promote Good Health for Employees and Their Families-How Business Can Improve Health Planning and Regulation. (\$20.00 per set; \$7.00 for individual monographs)

The Law of Product Liability: Problems and Policies

This study, prepared by the Legislative Drafting Research Fund of Columbia University, examines ways of making our nation's product liability laws less burdensome to industry without endangering the consumer. Preliminary drafts of the report convinced the Department of Commerce to revise its proposed model product liability law for the states. (\$22.95 for hard cover; \$15.95 for soft cover)

The Impact of the 1981-1982 Investment Incentives on Business Fixed Investment

This timely study, prepared by Dr. Michael Boskin, Professor of Economics at Stanford University, examines the impact of the investment incentives in the 1981-82 tax acts on business fixed investment in the United States. His findings reveal that investment incentives *do* work and that this should be carefully considered in any tax reform proposal. (\$10.00)

To order copies of these publications, or to obtain further information about the National Chamber Foundation, please contact: National Chamber Foundation, 1615 H Street, N.W., Washington, D.C. 20062, (202) 463-5552.

THIRD-QUARTER PERSONAL INCOME STATISTICS SHOW GAINS

The U.S. Department of Commerce reported that third quarter nonfarm personal income rose 1.1 percent. Those states which posted the largest gains are in New England and the South. New Hampshire showed the biggest improvement with a 2.1 percent gain, representing almost twice the national average. Large gains in personal income were also reported in South Carolina, Georgia, Tennessee, and Massachusetts.

Mississippi suffered the sharpest decline in personal income, a two percent drop, which was partially blamed on the damage to residential property caused by Hurricane Elena. Other states which showed declines or no change in personal income were Montana, West Virginia and Maine.

HELP-WANTED INDEX RISES

The Conference Board reported that its help-wanted advertising index rose one point in December from the previous month to 145, its highest level of last year.

The seasonally adjusted index, which uses the 1967 level as its base of 100, matched the year earlier figure. The index measures classified advertising in 51 major U.S. newspapers and is regarded as an indicator of demand for labor and of general business conditions.

The index, which measured 139 in January 1985, declined to the year's low of 131 in April and May. The sharpest gains in help-wanted advertising occurred in Dallas, Houston, and San Antonio, Texas; New Orleans, Louisiana; and Oklahoma City and Tulsa, Oklahoma. Advertising declined in parts of the West and New England.

PER CAPITA TAXES UP NEARLY TEN PERCENT IN 1984 REPORTS CENSUS BUREAU

The Census Bureau reported that per capita federal, state, and local government taxes in fiscal year 1984 rose 9.4 percent over 1983. Taxes collected by the three levels of government totaled \$3,112 per person, showing an increase of \$267 over the previous period. The federal government share of total tax revenues was 56 percent, the state government share was 27 percent, and the local government share, 17 percent.

The states which showed expenditures by state and local governments accounting for more than one-half of government spending below the federal level in 1984

were: California (\$74.1 billion), New York (\$65.0 billion), Texas (\$35.3 billion), Illinois (\$27.2 billion), Pennsylvania (\$26.6 billion), Ohio (\$25.4 billion), Michigan (\$25.4 billion), and Florida (\$23.4 billion).

WHAT DO 100 JOBS MEAN TO A COMMUNITY?

The findings of a 1984 study conducted by the Economic Policy Division have been published in *What 100 New Jobs Mean to a Community* which details the economic benefits, in terms of new businesses, nonmanufacturing jobs, increased personal income, an improved tax base, and much more, to a community when the manufacturing base is expanded.

The book outlines important strategies for communities trying to attract new manufacturing firms. According to the publication, a key element of attracting businesses to a community is to adopt fiscal and tax policy measures which favor industrial expansion thereby creating a healthy climate for business.

Copies of this informative study may be ordered by calling Susan Holliday, Special Products Division, (202) 463-5755.

AREA SURVEY PREDICTS GROWTH IN MANUFACTURING

The latest survey of manufacturers conducted by the Federal Reserve Bank of Philadelphia during the month of October shows that 52 percent of area manufacturers report no change in the rate of their operations, 22 percent report increasing activity, and 17 percent say business was slower for the month of October than in September.

With regard to specific measures of manufacturing activity, survey respondents noted some improvement in shipments and new orders. They reported that the level of unfilled orders had fallen off slightly, along with employment and working hours. The report states that October marks the tenth month in a row in which the number of firms reducing payrolls has exceed the number adding payrolls, the longest such period in a non-recession year. Despite this, manufacturing activity has either held steady or increased during these months.

In the near term, positive views prevail among the survey participants. Forty-three percent of the companies who participated expect improved business conditions over the next six months, compared to only 22 percent who are concerned that business conditions might decline. These companies forecast increases for new shipments, orders, and to a lesser extent, capital expenditures.

The majority of survey respondents report a steady trend in industrial prices, with no changes in the cost of either raw materials or the products they manufacture. Between now and March 1986, over half of the participants anticipate higher input costs, and 40 percent say they plan to charge more for their products.

POPULATION GROWTH OF 10 LARGEST METROPOLITAN STATISTICAL AREAS
1983-2000
(Millions)

	Population		Percent Change 1983-2000
	1983	2000	
West Palm Beach/Boca Raton, FL	659	1063	61.3%
Phoenix, AZ	1664	2573	54.6
Orlando, FL	793	1194	50.5
Riverside/San Bernardino, CA	1738	2465	41.9
Salt Lake City/Ogden, UT	1006	1363	35.5
Denver, CO	1562	2109	35.0
Tampa/St. Petersburg /Clearwater, FL	1770	2388	34.9
Houston, TX	3161	4262	34.8
Sacramento, CA	1197	1608	34.3
Fort Lauderdale/Hollywood /Pompano Beach, FL	1073	1431	33.3

Source: U.S. Department of Commerce, Bureau of Economic Analysis

The metropolitan areas which are projected to grow the fastest are located primarily in the southern section of the country, and those projected to experience the slowest growth rates are located in the Northeast and Great Lakes regions.

The nation's population is expected to grow by 14 percent between 1983 and 2000, and the fastest-growing metropolitan area in terms of population growth will be in West Palm Beach, followed by Phoenix and Orlando. Population in Cleveland is expected to fall by 8 percent, while in Detroit and Pittsburgh it is expected to decline by 2 percent. All other metropolitan areas are projected to experience population increases. The 10 metropolitan areas with the fastest projected population growth are located in the states of Florida, California, Texas, Arizona, Colorado and Utah.